

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Rod Pacheco Analyst: Jeani Brent Bill Number: AB 2170  
Related Bills: See Legislative History Telephone: 845-3410 Amended Date: 04/24/2000  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Net Operating Loss Sustained by Farmers from Pest Infestation/Allows 100% Deduction Carryover Until Used

### SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow special net operating loss (NOL) treatment for losses sustained by a farmer as a result of pest infestations.

### SUMMARY OF AMENDMENT

The April 24, 2000, amendments removed the provisions that would have allowed a credit equal to an unspecified amount of farm losses suffered by farmers in this state as a result of any natural disaster including pest infestations. These provisions have been replaced as discussed in this analysis.

### EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to taxable and income years beginning on or after January 1, 2000.

### LEGISLATIVE HISTORY

AB 2435 (2000) would allow taxpayers a 100% credit equal to the grape crop losses sustained by a grapevine grower because of the Glassy-Winged Sharpshooter pest or Pierce's Disease.

AB 2455 (2000) would allow a credit equal to the market price, as defined, of any unharvested fruit grown by a commercial grower that was lost as a direct result of the Fallbrook Mexican Fruit Fly Quarantine.

SB 2104 (2000) would provide an election to expense the cost of certain qualified property and a 100% net operating loss carryover for farmers that experience a "natural or quarantine event."

AB 122 (Stats. 1997, Ch. 607) allows accelerated depreciation for grapevines infested with Pierce's Disease.

SB 1778 (Stats. 1992, Ch. 960) allows accelerated depreciation for grapevines infested with phylloxera.

### Board Position:

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### Department Director

### Date

Alan Hunter for GHG

5/11/00

#### SPECIFIC FINDINGS

**Existing state and federal law** generally allows taxpayers engaged in a trade or business to deduct all expenses paid or incurred that are considered ordinary and necessary in conducting that trade or business.

**Under existing state and federal law**, any loss sustained during the year that is not compensated for by insurance or otherwise is allowed as a deduction. The amount of loss deduction generally is limited to the taxpayer's basis in the property that was lost.

**Existing state and federal law** define an NOL as the excess of allowable deductions over gross income computed under the law in effect for the loss year.

**Existing federal law** allows taxpayers to carry back NOLs two taxable years and to carry forward NOLs 20 taxable years.

**Existing state law** does not allow any carryback of NOLs. However, taxpayers may carryforward an NOL to subsequent years.

Depending on the type of taxpayer or amount of a taxpayer's income, the amount of the NOL that is eligible to be carried forward and the number of years it can be carried forward for state purposes will vary. For most taxpayers, 50% of the computed NOL may be carried forward for a maximum of five years. Special NOL treatment, as stated in the chart below, is provided for these specified taxpayers.

Type of NOL	Carryover %	Carryover Period
General NOL	50%	5 Years
New Business Year 1	100%	8 Years
Year 2	100%	7 Years
Year 3	100%	6 Years
Eligible Small Business	100%	5 Years
Economic Development Areas	100%	15 Years

**Under existing state and federal law**, taxpayers engaged in the business of farming are allowed to deduct the expenses related to planting and growing crops as an ordinary and necessary business expense.

**Under existing state and federal law**, farm losses may be deducted as an ordinary loss, limited to the taxpayer's adjusted basis, in the taxable or income year sustained. If not deducted as an ordinary loss, a taxpayer engaged in the trade or business of farming may include the farm loss in an NOL, subject to the carry back and carryforward as described above.

**This bill** would allow special NOL treatment for losses sustained by a farmer as a result of pest infestations. Specifically, 100% of the NOL sustained by a farmer as a result of pest infestation would be carried over. The NOL would be carried over until exhausted.

### Policy Considerations

Other special NOL treatment only allows a carryforward of 6, 7, 8, or 15 years. This bill would allow the NOL to be carried forward until completely used, creating a precedent.

Certain special state law NOL provisions, including enterprise zone and similar incentives, restrict use of the loss to income directly related to the loss. This bill would allow the NOL to be used against any income. However, pursuant to discussions with the author's staff, the attached amendments would allow the NOL to be used only against farming income, eliminating this concern.

The bill would apply to all farm losses, even those incurred as a result of pest infestations outside of California. However, by defining attributable income with reference to the taxpayer's California source farming business income, the amendments would have the effect of limiting the bill's application to farm losses within the state.

### Implementation Considerations

Pursuant to discussions with the author's staff, the attached amendments would modify the language to conform more closely to existing special NOL treatment provisions, as follows:

1. Allow taxpayers to elect to compute net operating losses either under this bill or under existing law.
2. Provide apportionment rules to ensure that only those losses attributable to the farm losses from pest infestation could be carried forward and deducted only against income attributable to farming. The formula used in the amendments is basically the same as that used in apportioning income and loss to an economic development area.

If the proposed amendments are accepted, implementing this bill would occur during the department's normal annual update.

### FISCAL IMPACT

#### Departmental Costs

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

#### Tax Revenue Estimate

The revenue losses from this bill, under the assumptions discussed below, are estimated to be relatively minor.

Revenue Impact of AB 2170 As Amended April 24, 2000 Enactment Assumed After June 30, 2000 (In Millions)			
Revenue Impact	2000-1	2001-2	2002-3
	-Minor	-\$0.5	-\$0.5

This analysis assumes only farm losses occurring in California would qualify, as proposed in the amendments. To the extent that farm losses occurring outside California would qualify, the revenue losses would be greater. The analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

#### Revenue Discussion

Contacts with California agricultural experts indicate that there are no state-level projections for losses resulting from all types of pest infestations. Based on information received from the State Department of Food and Agriculture and other sources, the amount of losses in California from Pierce's disease in 2000 is projected to be \$20 million. If, for this bill, the total amount of farm crop losses resulting from pest infestations were \$50 million, the potential NOL revenue loss would be about \$500,000.

For purposes of this revenue estimate, it was assumed that: Half of the total crop loss would be sustained by taxpayers with net operating losses overall (i.e., \$25 million) and that qualifying losses from pest infestations would account for 50% of those losses (i.e., \$12.5 million). Thus, the additional 50% NOL carryover deduction allowed under this bill would result in a \$500,000 revenue loss (\$6.25 million multiplied by an 8% tax rate).

#### BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 2170  
Amended April 24, 2000

AMENDMENT 1

**@@@@ Leg. Counsel:** Please replace Sections 1 and 2 of the bill with the following:

SECTION 1. Section 17276 of the Revenue and Taxation Code is amended to read:

17276. Except as provided in Sections 17276.1, 17276.2, 17276.4, 17276.5, ~~and 17276.6, and 17276.7,~~ the deduction provided by Section 172 of the Internal Revenue Code, relating to a net operating loss deduction, shall be modified as follows:

(a) (1) Net operating losses attributable to taxable years beginning before January 1, 1987, shall not be allowed.

(2) A net operating loss shall not be carried forward to any taxable year beginning before January 1, 1987.

(b) (1) Except as provided in paragraphs (2) and (3), the provisions of Section 172(b)(2) of the Internal Revenue Code, relating to the amount of carryovers, shall be modified so that 50 percent of the entire amount of the net operating loss for any taxable year shall not be eligible for carryover to any subsequent taxable year.

(2) In the case of a taxpayer who has a net operating loss in a taxable year beginning on or after January 1, 1994, and who operates a new business during that taxable year, each of the following shall apply to each loss incurred during the first three taxable years of operating the new business:

(A) If the net operating loss is equal to or less than the net loss from the new business, 100 percent of the net operating loss shall be carried forward as provided in paragraph (2) of subdivision (d).

(B) If the net operating loss is greater than the net loss from the new business, the net operating loss shall be carried over as follows:

(i) With respect to an amount equal to the net loss from the new business, 100 percent of that amount shall be carried forward as provided in paragraph (2) of subdivision (d).

(ii) With respect to the portion of the net operating loss which exceeds the net loss from the new business, 50 percent of that amount shall be a net operating loss carryover to each of the five taxable years following the taxable year of the loss.

(C) For purposes of Section 172(b)(2) of the Internal Revenue Code, the amount described in clause (ii) of subparagraph (B) shall be absorbed before the amount described in clause (i) of subparagraph (B).

(3) In the case of a taxpayer who has a net operating loss in a taxable year beginning on or after January 1, 1994, and who operates an eligible small business during that taxable year, each of the following shall apply:

(A) If the net operating loss is equal to or less than the net loss from the eligible small business, 100 percent of the net operating loss shall be carried forward to the taxable years specified in paragraph (1) of subdivision (d).

(B) If the net operating loss is greater than the net loss from the eligible small business, the net operating loss shall be carried over as follows:

(i) With respect to an amount equal to the net loss from the eligible small business, 100 percent of that amount shall be carried forward to each of the five taxable years following the taxable year of the loss.

(ii) With respect to the portion of the net operating loss that exceeds the net loss from the eligible small business, 50 percent of that amount shall be a net operating loss carryover to each of the five taxable years following the taxable year of the loss.

(C) For purposes of Section 172(b)(2) of the Internal Revenue Code, the amount described in clause (ii) of subparagraph (B) shall be absorbed before the amount described in clause (i) of subparagraph (B).

(4) In the case of a taxpayer who has a net operating loss in a taxable year beginning on or after January 1, 1994, and who operates a business that qualifies as both a new business and an eligible small business under this section, that business shall be treated as a new business for the first three taxable years of the new business.

(5) In the case of a taxpayer who has a net operating loss in a taxable year beginning on or after January 1, 1994, and who operates more than one business, and more than one of those businesses qualifies as either a new business or an eligible small business under this section, paragraph (2) shall be applied first, except that if there is any remaining portion of the net operating loss after application of clause (i) of subparagraph (B) of that paragraph, paragraph (3) shall be applied to the remaining portion of the net operating loss as though that remaining portion of the net operating loss constituted the entire net operating loss.

(6) For purposes of this section, the term "net loss" means the amount of net loss after application of Sections 465 and 469 of the Internal Revenue Code.

(c) Net operating loss carry backs shall not be allowed.

(d) (1) Except as provided in paragraphs (2) and (3), for each taxable year beginning on or after January 1, 1987, Section 172(b)(1)(A)(ii) of the Internal Revenue Code, relating to years to which net operating losses may be carried, is modified to substitute "five taxable years" in lieu of "20 taxable years."

(2) In the case of a "new business," the "five taxable years" in paragraph (1) shall be modified to read as follows:

(A) "Eight taxable years" for a net operating loss attributable to the first taxable year of that new business.

(B) "Seven taxable years" for a net operating loss attributable to the second taxable year of that new business.

(C) "Six taxable years" for a net operating loss attributable to the third taxable year of that new business.

(3) For any carryover of a net operating loss for which a deduction is denied by Section 17276.3, the carryover period specified in this subdivision shall be extended as follows:

(A) By one year for a net operating loss attributable to taxable years beginning in 1991.

(B) By two years for a net operating loss attributable to taxable years beginning prior to January 1, 1991.

(4) The net operating loss attributable to taxable years beginning on or after January 1, 1987, and before January 1, 1994, shall be a net operating loss carryover to each of the 10 taxable years following the year of the loss if it is incurred by a taxpayer that is under the jurisdiction of the court in a Title 11 or similar case at any time during the income year. The loss carryover provided in the preceding sentence shall not apply to any loss incurred after the date the taxpayer is no longer under the jurisdiction of the court in a Title 11 or similar case.

(e) For purposes of this section:

(1) "Eligible small business" means any trade or business that has gross receipts, less returns and allowances, of less than one million dollars (\$1,000,000) during the taxable year.

(2) Except as provided in subdivision (f), "new business" means any trade or business activity that is first commenced in this state on or after January 1, 1994.

(3) "Title 11 or similar case" shall have the same meaning as in Section 368(a)(3) of the Internal Revenue Code.

(4) In the case of any trade or business activity conducted by a partnership or S corporation, paragraphs (1) and (2) shall be applied to the partnership or S corporation.

(f) For purposes of this section, in determining whether a trade or business activity qualifies as a new business under paragraph (2) of subdivision (e), the following rules shall apply:

(1) In any case where a taxpayer purchases or otherwise acquires all or any portion of the assets of an existing trade or business (irrespective of the form of entity) that is doing business in this state (within the meaning of Section 23101), the trade or business thereafter conducted by the taxpayer (or any related person) shall not be treated as a new business if the aggregate fair market value of the acquired assets (including real, personal, tangible, and intangible property) used by the taxpayer (or any related person) in the conduct of its trade or business exceeds 20 percent of the aggregate fair market value of the total assets of the trade or business being conducted by the taxpayer (or any related person). For purposes of this paragraph only, the following rules shall apply:

(A) The determination of the relative fair market values of the acquired assets and the total assets shall be made as of the last day of the first taxable year in which the taxpayer (or any related person) first uses any of the acquired trade or business assets in its business activity.

(B) Any acquired assets that constituted property described in Section 1221(1) of the Internal Revenue Code in the hands of the transferor shall not be treated as assets acquired from an existing trade or business, unless those assets also constitute property described in Section 1221(1) of the Internal Revenue Code in the hands of the acquiring taxpayer (or related person).

(2) In any case where a taxpayer (or any related person) is engaged in one or more trade or business activities in this state, or has been engaged in one or more trade or business activities in this state within the preceding 36 months ("prior trade or business activity"), and thereafter commences an additional trade or business activity in this state, the additional trade or business activity shall only be treated as a new business if the additional trade or business activity is classified under a different division of the Standard Industrial Classification (SIC) Manual published by the United States Office of

Management and Budget, 1987 edition, than are any of the taxpayer's (or any related person's) current or prior trade or business activities.

(3) In any case where a taxpayer, including all related persons, is engaged in trade or business activities wholly outside of this state and the taxpayer first commences doing business in this state (within the meaning of Section 23101) after December 31, 1993 (other than by purchase or other acquisition described in paragraph (1)), the trade or business activity shall be treated as a new business under paragraph (2) of subdivision (e).

(4) In any case where the legal form under which a trade or business activity is being conducted is changed, the change in form shall be disregarded and the determination of whether the trade or business activity is a new business shall be made by treating the taxpayer as having purchased or otherwise acquired all or any portion of the assets of an existing trade or business under the rules of paragraph (1) of this subdivision.

(5) "Related person" shall mean any person that is related to the taxpayer under either Section 267 or 318 of the Internal Revenue Code.

(6) "Acquire" shall include any gift, inheritance, transfer incident to divorce, or any other transfer, whether or not for consideration.

(7) (A) For taxable years beginning on or after January 1, 1997, the term "new business" shall include any taxpayer that is engaged in biopharmaceutical activities or other biotechnology activities that are described in Codes 2833 to 2836, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, and as further amended, and that has not received regulatory approval for any product from the United States Food and Drug Administration.

(B) For purposes of this paragraph:

(i) "Biopharmaceutical activities" means those activities which use organisms or materials derived from organisms, and their cellular, subcellular, or molecular components, in order to provide pharmaceutical products for human or animal therapeutics and diagnostics. Biopharmaceutical activities make use of living organisms to make commercial products, as opposed to pharmaceutical activities which make use of chemical compounds to produce commercial products.

(ii) "Other biotechnology activities" means activities consisting of the application of recombinant DNA technology to produce commercial products, as well as activities regarding pharmaceutical delivery systems designed to provide a measure of control over the rate, duration, and site of pharmaceutical delivery.

(g) In computing the modifications under Section 172(d)(2) of the Internal Revenue Code, relating to capital gains and losses of taxpayers other than corporations, the exclusion provided by Section 18152.5 shall not be allowed.

(h) Notwithstanding any provisions of this section, a deduction shall be allowed to a "qualified taxpayer" as provided in Sections 17276.1, 17276.2, 17276.4, 17276.5, ~~and~~ 17276.6 and 17276.7.

(i) The Franchise Tax Board may prescribe appropriate regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, tiered ownership structures, or otherwise.

(j) The Franchise Tax Board may reclassify any net operating loss carryover determined under either paragraph (2) or (3) of subdivision (b) as a net operating loss carryover under paragraph (1) of subdivision (b) upon a showing that the reclassification is necessary to prevent evasion of the purposes of this section.



(k) The amendments made by the act adding this subdivision shall be operative for taxable years beginning on or after January 1, 1997.

SEC. 2. Section 17276.1 of the Revenue and Taxation Code is amended to read:

17276.1. (a) A qualified taxpayer, as defined in Section 17276.2, 17276.4, 17276.5, ~~or~~ 17276.6, or 17276.7, may elect to take the deduction provided by Section 172 of the Internal Revenue Code, relating to the net operating loss deduction, as modified by Section 17276, with the following exceptions:

(1) Subdivision (a) of Section 17276, relating to years in which allowable losses are sustained, shall not be applicable.

(2) Subdivision (b) of Section 17276, relating to the 50-percent reduction of losses, shall not be applicable.

(b) The election to compute the net operating loss under this section shall be made in a statement attached to the original return, timely filed for the year in which the net operating loss is incurred and shall be irrevocable. In addition to the exceptions specified in subdivision (a), the provisions of Section 17276.2, 17276.4, 17276.5, ~~or~~ 17276.6, or 17276.7, as appropriate, shall be applicable.

(c) Any carryover of a net operating loss sustained by a qualified taxpayer, as defined in subdivision (a) or (b) of Section 17276.2 as that section read immediately prior to January 1, 1997, shall, if previously elected, continue to be a deduction, as provided in subdivision (a), applied as if the provisions of subdivision (a) or (b) of Section 17276.2, as that section read prior to January 1, 1997, still applied.

SEC. 3. Section 17276.7 is added to the Revenue and Taxation Code, to read:

17276.7. (a) The term "qualified taxpayer" as used in Section 17276.1 includes a person or entity that conducts a farming business. For purposes of this subdivision, all of the following shall apply:

(1) A net operating loss shall not be a net operating loss carryback to any taxable year, and a net operating loss for any taxable year beginning on or after the date that the area in which the taxpayer conducts a farming business is affected by pest infestation shall be a net operating loss carryover to each of the taxable years following the taxable year of loss, until used.

(2) For purposes of this subdivision:

(A) "Net operating loss" means the loss determined under Section 172 of the Internal Revenue Code, as modified by Section 17276.1, attributable to the taxpayer's farming business activities within the area affected by the pest infestation. That attributable loss shall be determined in accordance with Chapter 17 (commencing with Section 25101) of Part 11, modified for purposes of this subdivision, as follows:

(i) A loss shall be apportioned to the area affected by the pest infestation by multiplying the total loss from the farming business by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two.

(ii) "The area affected by pest infestation" shall be substituted for "this state."

(B) A net operating loss carryover computed under this section shall be allowed as a deduction only with respect to the taxpayer's farming business income attributable to the area affected by the pest infestation.

(C) Attributable income is that portion of the taxpayer's California source farming business income that is apportioned to the area affected by the pest infestation. For that purpose, the taxpayer's farming business income attributable to sources in this state first shall be determined in accordance with Chapter 17 (commencing with Section 25101) of Part 11. That farming business income shall be further apportioned to the area affected by the pest infestation in accordance with Article 2 (commencing with Section 25120) of Chapter 17 of Part 11, modified for purposes of this subdivision as follows:

(i) Farming business income shall be apportioned to the area affected by the pest infestation by multiplying the total California farming business income of the taxpayer by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two. For purposes of this clause:

(I) The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in the area affected by the pest infestation during the taxable year, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year.

(II) The payroll factor is a fraction, the numerator of which is the total amount paid by the taxpayer in the area affected by the pest infestation during the taxable year for compensation, and the denominator of which is the total compensation paid by the taxpayer in this state during the taxable year.

(ii) If a loss carryover is allowable pursuant to this section for any taxable year after the pest infestation occurred, the area affected by the pest infestation shall be deemed to remain in existence for purposes of computing the limitation set forth in subparagraph (B) and allowing a net operating loss deduction.

(b) A taxpayer who qualifies as a "qualified taxpayer" under one or more sections shall, for the taxable year of the net operating loss and any taxable year to which that net operating loss may be carried, designate on the original return filed for each year the section that applies to that taxpayer with respect to that net operating loss. If the taxpayer is eligible to qualify under more than one section, the designation is to be made after taking into account subdivision (c).

(c) If a taxpayer is eligible to compute its net operating loss under this section and either Section 17276.2, 17276.4, 17276.5, or 17276.6 as a "qualified taxpayer," with respect to a net operating loss in a taxable year, the taxpayer shall designate which section is to apply to the taxpayer.

(d) Notwithstanding Section 17276, the amount of the loss determined under this section or Section 17276.2, 17276.4, 17276.5, or 17276.6 shall be the only net operating loss allowed to be carried over from that taxable year and the designation under subdivision (b) shall be included in the election under Section 17276.1.

SEC. 4. Section 24416 of the Revenue and Taxation Code is amended to read:

24416. Except as provided in Section 24416.1, 24416.2, 24416.4, 24416.5, ~~or~~ 24416.6, or 24416.7, a net operating loss deduction shall be allowed in computing net income under Section 24341 and shall be determined in accordance with Section 172 of the Internal Revenue Code, except as otherwise provided.

(a) (1) Net operating losses attributable to income years beginning before January 1, 1987, shall not be allowed.

(2) A net operating loss shall not be carried forward to any income year beginning before January 1, 1987.

(b) (1) Except as provided in paragraphs (2) and (3), the provisions of Section 172(b)(2) of the Internal Revenue Code, relating to the amount of carryovers, shall be modified so that 50 percent of the entire amount of the net operating loss for any income year shall not be eligible for carryover to any subsequent income year.

(2) In the case of a taxpayer who has a net operating loss in an income year beginning on or after January 1, 1994, and who operates a new business during that income year, each of the following shall apply to each loss incurred during the first three income years of operating the new business:

(A) If the net operating loss is equal to or less than the net loss from the new business, 100 percent of the net operating loss shall be carried forward as provided in paragraph (2) of subdivision (e).

(B) If the net operating loss is greater than the net loss from the new business, the net operating loss shall be carried over as follows:

(i) With respect to an amount equal to the net loss from the new business, 100 percent of that amount shall be carried forward as provided in paragraph (2) of subdivision (e).

(ii) With respect to the portion of the net operating loss that exceeds the net loss from the new business, 50 percent of that amount shall be a net operating loss carryover to each of the five taxable years following the taxable year of the loss.

(C) For purposes of Section 172(b)(2) of the Internal Revenue Code, the amount described in clause (ii) of subparagraph (B) shall be absorbed before the amount described in clause (i) of subparagraph (B).

(3) In the case of a taxpayer who has a net operating loss in an income year beginning on or after January 1, 1994, and who operates an eligible small business during that income year, each of the following shall apply:

(A) If the net operating loss is equal to or less than the net loss from the eligible small business, 100 percent of the net operating loss shall be carried forward to the income years specified in paragraph (1) of subdivision (e).

(B) If the net operating loss is greater than the net loss from the eligible small business, the net operating loss shall be carried over as follows:

(i) With respect to an amount equal to the net loss from the eligible small business, 100 percent of that amount shall be carried forward to each of the five income years following the income year of the loss.

(ii) With respect to the portion of the net operating loss that exceeds the net loss from the eligible small business, 50 percent of that amount shall be a net operating loss carryover to each of the five income years following the income year of the loss.

(C) For purposes of Section 172(b)(2) of the Internal Revenue Code, the amount described in clause (ii) of subparagraph (B) shall be absorbed before the amount described in clause (i) of subparagraph (B).

(4) In the case of a taxpayer who has a net operating loss in an income year beginning on or after January 1, 1994, and who operates a business that qualifies as both a new business and an eligible small business under this section, that business shall be treated as a new business for the first three income years of the new business.

(5) In the case of a taxpayer who has a net operating loss in an income year beginning on or after January 1, 1994, and who operates more than one business, and more than one of those businesses qualifies as either a new business or an eligible small business under this section, paragraph (2) shall be applied first, except that if there is any remaining portion of the net operating loss after application of clause (i) of subparagraph (B) of paragraph (2), paragraph (3) shall be applied to the remaining portion of the net operating loss as though that remaining portion of the net operating loss constituted the entire net operating loss.

(6) For purposes of this section, "net loss" means the amount of net loss after application of Sections 465 and 469 of the Internal Revenue Code.

(c) For any income year in which the taxpayer has in effect a water's-edge election under Section 25110, the deduction of a net operating loss carryover shall be denied to the extent that the net operating loss carryover was determined by taking into account the income and factors of an affiliated corporation in a combined report whose income and apportionment factors would not have been taken into account if a water's-edge election under Section 25110 had been in effect for the income year in which the loss was incurred.

(d) Net operating loss carrybacks shall not be allowed.

(e) (1) Except as provided in paragraphs (2), (3), and (4), for each income year beginning on or after January 1, 1987, Section 172 (b)(1)(A)(ii) of the Internal Revenue Code, relating to years to which net operating losses may be carried, is modified to substitute "five income years" in lieu of "20 taxable years."

(2) In the case of a "new business," the "five income years" referred to in paragraph (1) shall be modified to read as follows:

(A) "Eight income years" for a net operating loss attributable to the first income year of that new business.

(B) "Seven income years" for a net operating loss attributable to the second income year of that new business.

(C) "Six income years" for a net operating loss attributable to the third income year of that new business.

(3) For any carryover of a net operating loss for which a deduction is denied by Section 24416.3, the carryover period specified in this subdivision shall be extended as follows:

(A) By one year for a net operating loss attributable to income years beginning in 1991.

(B) By two years for a net operating loss attributable to income years beginning prior to January 1, 1991.

(4) The net operating loss attributable to income years beginning on or after January 1, 1987, and before January 1, 1994, shall be a net operating loss carryover to each of the 10 income years following the year of the loss if it is incurred by a corporation that was either of the following:

(A) Under the jurisdiction of the court in a Title 11 or similar case at any time prior to January 1, 1994. The loss carryover provided in the preceding sentence shall not apply to any loss incurred in an income year after the income year during which the corporation is no longer under the jurisdiction of the court in a Title 11 or similar case.

(B) In receipt of assets acquired in a transaction that qualifies as a tax-free reorganization under Section 368(a)(1)(G) of the Internal Revenue Code.

(f) For purposes of this section:

(1) "Eligible small business" means any trade or business that has gross receipts, less returns and allowances, of less than one million dollars (\$1,000,000) during the income year.

(2) Except as provided in subdivision (g), "new business" means any trade or business activity that is first commenced in this state on or after January 1, 1994.

(3) "Title 11 or similar case" shall have the same meaning as in Section 368(a)(3) of the Internal Revenue Code.

(4) In the case of any trade or business activity conducted by a partnership or an S corporation, paragraphs (1) and (2) shall be applied to the partnership or S corporation.

(g) For purposes of this section, in determining whether a trade or business activity qualifies as a new business under paragraph (2) of subdivision (e), the following rules shall apply:

(1) In any case where a taxpayer purchases or otherwise acquires all or any portion of the assets of an existing trade or business (irrespective of the form of entity) that is doing business in this state (within the meaning of Section 23101), the trade or business thereafter conducted by the taxpayer (or any related person) shall not be treated as a new business if the aggregate fair market value of the acquired assets (including real, personal, tangible, and intangible property) used by the taxpayer (or any related person) in the conduct of its trade or business exceeds 20 percent of the aggregate fair market value of the total assets of the trade or business being conducted by the taxpayer (or any related person). For purposes of this paragraph only, the following rules shall apply:

(A) The determination of the relative fair market values of the acquired assets and the total assets shall be made as of the last day of the first income year in which the taxpayer (or any related person) first uses any of the acquired trade or business assets in its business activity.

(B) Any acquired assets that constituted property described in Section 1221(1) of the Internal Revenue Code in the hands of the transferor shall not be treated as assets acquired from an existing trade or business, unless those assets also constitute property described in Section 1221(1) of the Internal Revenue Code in the hands of the acquiring taxpayer (or related person).

(2) In any case where a taxpayer (or any related person) is engaged in one or more trade or business activities in this state, or has been engaged in one or more trade or business activities in this state within the preceding 36 months ("prior trade or business activity"), and thereafter commences an additional trade or business activity in this state, the additional trade or business activity shall only be treated as a new business if the additional trade or business activity is classified under a different division of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, than are any of the taxpayer's (or any related person's) current or prior trade or business activities.

(3) In any case where a taxpayer, including all related persons, is engaged in trade or business activities wholly outside of this state and the taxpayer first commences doing business in this state (within the meaning of Section 23101) after December 31, 1993 (other than by purchase or other acquisition described in paragraph (1)), the trade or business activity shall be treated as a new business under paragraph (2) of subdivision (e).

(4) In any case where the legal form under which a trade or business activity is being conducted is changed, the change in form shall be disregarded and the determination of whether the trade or business activity is a new business shall be made by treating the taxpayer as having purchased or otherwise acquired all or any portion of the assets of an existing trade or business under the rules of paragraph (1) of this subdivision.

(5) "Related person" shall mean any person that is related to the taxpayer under either Section 267 or 318 of the Internal Revenue Code.

(6) "Acquire" shall include any transfer, whether or not for consideration.

(7) (A) For income years beginning on or after January 1, 1997, the term "new business" shall include any taxpayer that is engaged in biopharmaceutical activities or other biotechnology activities that are described in Codes 2833 to 2836, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, and as further amended, and that has not received regulatory approval for any product from the United States Food and Drug Administration.

(B) For purposes of this paragraph:

(i) "Biopharmaceutical activities" means those activities which use organisms or materials derived from organisms, and their cellular, subcellular, or molecular components, in order to provide pharmaceutical products for human or animal therapeutics and diagnostics. Biopharmaceutical activities make use of living organisms to make commercial products, as opposed to pharmaceutical activities which make use of chemical compounds to produce commercial products.

(ii) "Other biotechnology activities" means activities consisting of the application of recombinant DNA technology to produce commercial products, as well as activities regarding pharmaceutical delivery systems designed to provide a measure of control over the rate, duration, and site of pharmaceutical delivery.

(h) For purposes of corporations whose net income is determined under Chapter 17 (commencing with Section 25101), Section 25108 shall apply to each of the following:

(1) The amount of net operating loss incurred in any income year which may be carried forward to another income year.

(2) The amount of any loss carry forward which may be deducted in any income year.

(i) The provisions of Section 172(b)(1)(D) of the Internal Revenue Code, relating to bad debt losses of commercial banks, shall not be applicable.

(j) The Franchise Tax Board may prescribe appropriate regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, tiered ownership structures, or otherwise.

(k) The Franchise Tax Board may reclassify any net operating loss carryover determined under either paragraph (2) or (3) of subdivision (b) as a net operating loss carryover under paragraph (1) of subdivision (b) upon a showing that the reclassification is necessary to prevent evasion of the purposes of this section.

(l) The amendments made by the act adding this subdivision shall be operative for income years beginning on or after January 1, 1997.

SEC. 5. Section 24416.1 of the Revenue and Taxation Code is amended to read:

24416.1. (a) A qualified taxpayer, as defined in Section 24416.2, 24416.4, 24416.5, ~~or~~ 24416.6, or 24416.7, may elect to take the deduction provided by

Section 172 of the Internal Revenue Code, relating to the net operating loss deduction, as modified by Section 24416, in computing net income under Section 24341, with the following exceptions to Section 24416:

(1) Subdivision (a) of Section 24416, relating to years in which allowable losses are sustained, shall not be applicable.

(2) Subdivision (b) of Section 24416, relating to the 50-percent reduction of losses, shall not be applicable.

(3) The provisions of subparagraphs (B) and (C) of Section 172 (b) (1) of the Internal Revenue Code shall not apply. To the extent applicable to California law, net operating losses attributable to entities with losses described by Section 172(b)(1)(J) shall be applied in accordance with Section 172(b)(1)(A) and (B) of the Internal Revenue Code.

(b) Corporations whose income is subject to the provisions of Section 25101 or 25101.15 shall make the computations required by Section 25108.

(c) The election to compute the net operating loss under this section shall be made in a statement attached to the original return, timely filed for the year in which the net operating loss is incurred and shall be irrevocable. In addition to the exceptions specified in subdivision (a), Section 24416.2, 24416.4, 24416.5, ~~or~~ 24416.6, or 24416.7, as appropriate, shall be applicable.

(d) Any carryover of a net operating loss sustained by a qualified taxpayer, as defined in subdivision (a) or (b) of Section 24416.2 as that section read immediately prior to January 1, 1997, shall, if previously elected, continue to be a deduction, as provided in subdivision (a), applied as if the provisions of subdivision (a) or (b) of Section 24416.2, as that section read prior to January 1, 1997, still applied.

SEC. 6. Section 24416.7 is added to the Revenue and Taxation Code, to read:

24416.7. (a) The term "qualified taxpayer" as used in Section 24416.1 includes a corporation that conducts a farming business. For purposes of this subdivision, all of the following shall apply:

(1) A net operating loss shall not be a net operating loss carryback to any income year, and a net operating loss for any income year beginning on or after the date that the area in which the taxpayer conducts a farming business is affected by pest infestation shall be a net operating loss carryover to each of the income years following the income year of loss, until used.

(2) For purposes of this subdivision:

(A) "Net operating loss" means the loss determined under Section 172 of the Internal Revenue Code, as modified by Section 24416.1, attributable to the taxpayer's farming business activities within the area affected by the pest infestation. That attributable loss shall be determined in accordance with Chapter 17 (commencing with Section 25101), modified for purposes of this subdivision, as follows:

(i) A loss shall be apportioned to the area affected by the pest infestation by multiplying the total loss from the farming business by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two.

(ii) "The area affected by pest infestation" shall be substituted for "this state."

(B) A net operating loss carryover computed under this section shall be allowed as a deduction only with respect to the taxpayer's farming business income attributable to the area affected by the pest infestation.

(C) Attributable income is that portion of the taxpayer's California source farming business income that is apportioned to the area affected by the pest infestation. For that purpose, the taxpayer's farming business income attributable to sources in this state first shall be determined in accordance with Chapter 17 (commencing with Section 25101). That farming business income shall be further apportioned to the area affected by the pest infestation in accordance with Article 2 (commencing with Section 25120) of Chapter 17, modified for purposes of this subdivision as follows:

(i) Farming business income shall be apportioned to the area affected by the pest infestation by multiplying the total California farming business income of the taxpayer by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two. For purposes of this clause:

(I) The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in the area affected by the pest infestation during the income year, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used in this state during the income year.

(II) The payroll factor is a fraction, the numerator of which is the total amount paid by the taxpayer in the area affected by the pest infestation during the income year for compensation, and the denominator of which is the total compensation paid by the taxpayer in this state during the income year.

(ii) If a loss carryover is allowable pursuant to this section for any income year after the pest infestation occurred, the area affected by the pest infestation shall be deemed to remain in existence for purposes of computing the limitation set forth in subparagraph (B) and allowing a net operating loss deduction.

(b) A taxpayer who qualifies as a "qualified taxpayer" under one or more sections shall, for the income year of the net operating loss and any income year to which that net operating loss may be carried, designate on the original return filed for each year the section that applies to that taxpayer with respect to that net operating loss. If the taxpayer is eligible to qualify under more than one section, the designation is to be made after taking into account subdivision (c).

(c) If a taxpayer is eligible to compute its net operating loss under this section and either Section 24416.2, 24416.4, 24416.5, or 24416.6 as a "qualified taxpayer," with respect to a net operating loss in a income year, the taxpayer shall designate which section is to apply to the taxpayer.

(d) Notwithstanding Section 24416, the amount of the loss determined under this section or Section 24416.2, 24416.4, 24416.5, or 24416.6 shall be the only net operating loss allowed to be carried over from that income year and the designation under subdivision (b) shall be included in the election under Section 24416.1.